CHARLES ELMORE CROPLEY
CLERK

Nos. 682 and 683

In the Supreme Court of the United States

OCTOBER TERM, 1939

J. STEVE ANDERSON, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

L. H. PRICHARD, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 15–16) is unreported. The opinion of the Circuit Court of Appeals for the Tenth Circuit (R. 74–79) is reported in 107 F. (2d) 459.

JURISDICTION

The judgment of the Circuit Court of Appeals for the Tenth Circuit was entered on November 1, 1939 (R. 79). A petition for writs of certiorari was filed January 30, 1940, and granted March 4, 1940. The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

A sold oil lands and rights to B for $50,000, plus an additional $110,000 to be paid out of one-half of the proceeds received by B from oil and gas produced from the properties and from the sale of any of the lands conveyed to him. In 1932 B received income by way of proceeds from the properties, one-half of which he paid over to A in pursuance of the above arrangement. Is B to be relieved of income tax upon the proceeds thus paid over to A?

STATUTE INVOLVED

Revenue Act of 1932, c. 209, 47 Stat. 169:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; * * *.

STATEMENT[1]

The facts, as found by the Board of Tax Appeals (R. 14–15), may be summarized as follows:

On March 19, 1931, Oklahoma City Company entered into a written contract with petitioner Prichard providing for the sale to Prichard of certain royalty interests, fee interests, and deferred oil payments in properties in Oklahoma. Prichard agreed to pay the Company $50,000 in cash and also one-half of the proceeds received by him from the sale of oil and gas produced from the properties and from the sale of any of the lands conveyed to him, until the Company had received $110,000 in addition to the $50,000. Interest at the rate of 6% per annum was to be paid from proceeds of sales or production upon any unpaid balance of the $110,000. The Company transferred the properties to Prichard immediately but retained a lien upon the properties and products to secure payment of the $110,000 and interest. (R. 14, 16–23.)

On March 23, 1931, Prichard assigned an interest in the properties covered by this contract to

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[1] These two cases present precisely the same questions of law arising upon the same state of facts. In the Board of Tax Appeals, the cases were consolidated with each other and with a similar proceeding brought by one Olsen. The findings of fact made by the Board relate to all three cases and all of them were disposed of in a single opinion. Each of the petitioners before the Board filed a petition for review in the court below, where the cases were also consolidated and disposed of in a single opinion. Olsen did not file a petition for a writ of certiorari.

Oil Brokerage and Investment Company (hereinafter referred to as Investment Company) in consideration of $50,000 cash. The contract of assignment provided that the Investment Company was to receive all revenues received from the properties by Prichard until the Investment Company had received $50,000 and that thereafter the Investment Company and Prichard were each to own an undivided one-half interest in the properties. Prichard agreed that if the revenues were insufficient to reimburse the Investment Company for the $50,000 advanced as consideration for the assignment, he would bear one-half of the loss. (R. 14, 24–25.)

In entering into these agreements Prichard acted not only for himself but also for petitioner Anderson and for one Olsen, as set forth in a declaration of trust dated March 23, 1931. Prichard and Anderson each had a 45 percent interest and Olsen had a ten percent interest. (R. 14, 25–27.)

The gross proceeds from sales and from oil and gas produced from the properties amounted to $55,833.17 in 1931. Prichard received these proceeds and distributed them in equal amounts to the Oklahoma Company and the Investment Company. In 1932, the tax year here involved, the gross proceeds received by Prichard amounted to $81,547.15. He paid one-half of this amount to the Oklahoma Company. To the Investment Company, he paid $23,695.91 (representing the balance necessary to reimburse it for the $50,000 advanced as considera-

tion for the assignment) plus one-half of the remainder. Of the remaining amount, he kept 45 percent, paid Anderson 45 percent, and paid Olsen 10 percent. (R. 15.)

Both Prichard and Anderson reported $3,165.19 as income received during 1932 from these transactions. The Commissioner added $11,276.39 to the income of each, stating in his notice of deficiency that this amount represented "In-oil payments" received in connection with the transaction and not reported as income. (R. 15.) He accordingly determined a deficiency of $1,918.60 against Prichard and $2,724.91 against Anderson.

The Commissioner's action was sustained by the Board of Tax Appeals, which stated (R. 16):

> The Commissioner treated all receipts less depletion as income, and regarded the disbursements to Oklahoma City Company, and perhaps part of those to Oil Brokerage, as payments of the purchase price of $160,000. We can find no error in this action of the Commissioner.

The court below agreed with the Board that the Commissioner had correctly included in the petitioners' gross income the amount of the disbursements to the Oklahoma Company (R. 76–78). It then held that $25,000 of the $50,000 paid to the Investment Company to reimburse it for the amount which it had advanced as consideration for the assignment was not taxable against the petitioners. Being unable to determine from the rec-

ord whether more than $25,000 of the $50,000 had been assessed to the petitioners, it remanded the cases to the Board for determination of this question. (R. 78–79.)

The Government has not sought review of the action of the court below in remanding the cases to the Board for further proceedings in connection with the payments to the Investment Company. The only question presented to this Court, therefore, is whether the court below properly held that petitioners' contractual obligation to pay over one-half of the gross proceeds from the properties to the Oklahoma Company did not relieve petitioners of income tax upon such proceeds. In considering this question, the assignment to the Investment Company may be, and in the ensuing discussion will be, disregarded.

SUMMARY OF ARGUMENT

The contract of March 19, 1931, provided for an outright sale of the properties to petitioners for a consideration of $160,000, payable $50,000 in cash and $110,000 from one-half of the proceeds from the properties if, as, and when received. After the execution of the contract, all legal and equitable interests in the properties belonged to petitioners, subject only to the Oklahoma Company's lien to secure payment of the $110,000. Since petitioners were the absolute owners of the properties, all the income derived from the properties was their income; the fact that they were under a contractual

obligation to pay over one-half of the proceeds from the properties in payment of the purchase price did not affect either the nature of their ownership of the properties or the nature of their interest in the proceeds of the properties.

Thomas v. *Perkins*, 301 U. S. 655, is readily distinguishable. That case involved an assignment of lease providing for oil payments to the assignor. In holding that the assignee was not required to include in his gross income any part of the proceeds of the oil that went to the assignor, the Court expressly based decision upon the particular terms of the instrument of assignment which it construed as withholding from the operation of the grant an amount of oil sufficient, when sold, to yield the amount of the oil payment. The contract here is substantially different. It provided for transfer of all the properties to petitioners without the reservation of any sort of interest except a lien, and its terms clearly negative any contention that the Oklahoma Company withheld from the operation of the grant an amount of oil equivalent, when sold, to the $110,000 which the Company was entitled to receive. Petitioners had the right to sell and convey the properties covered by the contract and pay the $110,000 out of the proceeds of such sale rather than out of the proceeds of gas and oil produced from the properties. This right is plainly inconsistent with the view that the Oklahoma Company retained an interest in the oil and gas in place.

Moreover, in *Thomas* v. *Perkins,* the oil payments were to be made in kind, while in the present case they were to be made in cash. A holding that a lessee who merely produces oil and turns it over to the lessor has not derived income from the oil is not authority for a holding that a lessee who produces and sells oil and receives the proceeds therefrom has not realized income because he is under a contractual obligation to turn over a portion of the proceeds to the lessor in payment of the purchase price.

Palmer v. *Bender,* 287 U. S. 551, is similarly distinguishable. That case involved an assignment of a lease in return for a cash bonus, a future payment of a specified sum to be made out of a percentage of the oil produced, and an excess royalty of one-eighth of all the oil produced. The Court held that the assignors were entitled to a depletion allowance with respect to payments made under this assignment because they had retained a right to share in the oil in place which was depleted by production. In the present case the Oklahoma Company had no right to share in the oil in place and retained no capital investment in the properties; *Palmer* v. *Bender, supra,* is, therefore, inapplicable to the situation here presented.

Petitioner's contention that Prichard acted as a mere instrumentality or agency for collecting, receiving, and paying over to the Oklahoma Company money which belonged to it is necessarily based on

the premise that the Oklahoma Company reserved an interest in the oil in place. Since the premise is without foundation, the contention is devoid of merit.

ARGUMENT

1. On principle, the decision of the court below is entirely correct. The contract of March 19, 1931, provided for an outright sale of the properties to Prichard [2] for a consideration of $160,000, payable $50,000 in cash and $110,000 from one-half of the proceeds from the properties if, as and when received (R. 21). After the execution of the contract, all legal and equitable interests in the properties belonged to Prichard, subject only to the Oklahoma Company's lien to secure payment of the $110,000; as stated in the petition for certiorari (p. 15), "the instruments of transfer * * * were absolute and unqualified assignments and conveyances" and there was "no reservation of any sort of interest, much less any legal interest, specified in those assignments and conveyances" (see also Pet. 5). Since Prichard was the absolute owner of the properties it seems clear that all the income derived from those properties was *his* income, despite the fact that he was under contrac-

[2] As pointed out in the Statement, in the transactions with the Oklahoma Company Prichard was acting for himself, for Anderson and for Olsen, who did not file a petition with this Court. However, for purposes of convenience, we shall discuss the question as though Prichard had acted solely for himself.

tual obligation to pay one-half of it over to the Oklahoma Company after he received it.[3]

It is axiomatic that the statute taxes income to the owner of the property which produces it. *Helvering* v. *Clifford*, No. 383, present Term; *Poe* v. *Seaborn*, 282 U. S. 101. Such taxation may not be avoided by payment of the income to others in accordance with a prearranged plan, because the use to which income derived from property is put after its receipt by the owner of the property is of no consequence. The owner of property is subject to tax on the income from the property even though he has previously made an assignment of the in-

[3] The properties acquired from the Oklahoma Company consisted of "certain royalty interests, fee ownership, and deferred oil payments" (R. 17) and certain "working interests" (R. 19). The gross proceeds from sales and from oil and gas produced from the properties in 1932 amounted to $81,547.15, of which one-half was distributed to the Oklahoma Company. The record does not indicate what portion of the gross proceeds was derived from the production and sale of oil and gas and what portion, if any, was derived from sales of fees and from royalties on leases (R. 16). However, the Commissioner, in determining deficiencies against the petitioners, added $11,276.39 to the gross income of each, explaining that this amount represented "In-oil payments received in connection with the Patterson [Oklahoma City Co.] deal * * *" which had not been reported by petitioners (R. 15, 11, 48). In view of this explanation by the Commissioner, and because the record nowhere discloses how the amount of $11,276.39 was computed, we shall accept for purposes of this review petitioners' statement that "the only income from the properties here in dispute is from oil production" (Pet. 9).

come (see *Reinecke* v. *Smith*, 289 U. S. 172, 177, citing *Lucas* v. *Earl*, 281 U. S. 111, and *Burnet* v. *Leininger*, 285 U. S. 136) or has agreed to apply it to the discharge of an obligation. *Old Colony Trust Co.* v. *Commissioner*, 279 U. S. 716; *Reynolds* v. *McMurray*, 60 F. (2d) 843 (C. C. A. 10th), certiorari denied, 287 U. S. 664; *Hill* v. *Commissioner*, 38 F. (2d) 165 (C. C. A. 1st), certiorari denied, 281 U. S. 761. Cf. *Bull* v. *United States*, 295 U. S. 247, 254; *Douglas* v. *Willcuts*, 296 U. S. 1. Since the income here involved was derived from property of which Prichard was the owner, the Commissioner was plainly justified in taxing it to Prichard.

2. *Thomas* v. *Perkins*, 301 U. S. 655, relied upon by petitioners, is clearly distinguishable. That case involved an assignment of oil leases pursuant to which the assignors were to receive $395,000 "to be paid out of the oil produced and saved from the * * * lands, and to be one-fourth of all the oil produced and saved * * * until the full sum * * * is paid * * *" (p. 657). It was agreed between the parties that the $395,000 was payable out of oil only and that it should not be a personal obligation of the asignee. The instrument did not purport to reserve a lien. The Court held that, while the granting clause in the coveyance would be sufficient, if standing alone, to transfer all of the oil to the asignee, the granting clause was

qualified or modified by other parts of the instrument. The Court stated (301 U. S. at 659):

> The provisions for payment to assignors in oil only, the absence of any obligation of the assignee to pay in oil or in money, and the failure of assignors to take any security by way of lien or otherwise unmistakably show *that they intended to withhold from the operation of the grant one-fourth of the oil to be produced and saved up to an amount sufficient when sold to yield $395,000* [italics supplied].

This construction of the assignment was supported by the fact that when the oil was sold, the purchaser was furnished with a division order designating the quantities of the oil belonging to the assignors and the assignee and directing that a proportionate part of the purchase price be paid directly to the assignors. Under these circumstances, the Court held that the moneys received by the assignors from the sale of the oil was not income to the assignee. The basis for the decision was that ownership of the oil from the sale of which these moneys were derived had not been conveyed to the assignee but remained in the assignors.

The contract here involved is substantially different. It provided for a transfer of all of the properties to Prichard and there was no modifying or qualifying language reserving any sort of interest in the Oklahoma Company. The agreement (R. 20) recited that the Oklahoma Company desired "to sell all of its right, title and interest of whatsoever

nature," and agreed to deliver to Prichard good and valid instruments conveying the various interests referred to. Provision was made for an adjustment in the amount of the deferred payments "if for any reason it [Oklahoma Company] should fail to deliver satisfactory title to any of the lots" (R. 20-21). The $110,000 deferred payment drew interest until paid (R. 21), and the Oklahoma Company had a first lien and claim against one-half of the oil and gas production and fee interest (R. 21). The court below pertinently observed (R. 77) that "These provisions are wholly inconsistent with an intent to reserve any interest in the Oklahoma Company other than a lien on the properties or the proceeds derived therefrom. The Oklahoma Company could not retain title to property and at the same time reserve a lien thereon."

Moreover, Prichard had the right to sell and convey the properties and interests covered by the contract and pay the $110,000 out of the proceeds of such sale rather than out of the proceeds of gas and oil produced from the properties. Such a right would seem plainly to negative any idea that the Oklahoma Company retained an interest in the oil in place. Again, the contract did not provide for direct payment to the Oklahoma Company by purchasers of the oil and gas of one-half of the purchase price; on the contrary, it expressly provided that the purchase price should be paid directly to Prichard and that he should deposit one-half of the payments to the Oklahoma Company's credit

at intervals of 90 days at a designated bank (R. 22). Finally, the provision that a copy of the agreement and a "release" be placed in escrow for delivery to Prichard upon full payment of the $110,000 and interest (R. 22) indicates that the parties intended an outright sale; this provision clearly contemplates the extinction of a lien rather than the transfer of title or a beneficial interest, for which purpose a deed would normally be employed.

Accepting the stated premise of the opinion in *Thomas* v. *Perkins*—that the decision was based on a construction of the particular agreement as withholding from the operation of the grant sufficient oil to make the oil payments—the distinctions pointed out above are clearly substantial. There the oil which produced the income was considered not to have been conveyed to the taxpayer and he was therefore held not to be taxable on that income; here, on the other hand, the taxpayers clearly received a conveyance of all the properties and therefore they are taxable on the income derived from the properties. Just such a distinction has been drawn by the lower federal courts and by the Board of Tax Appeals in cases where services, usually by a drilling company, are performed for an operating lessee in consideration of his promise to pay a specified sum out of a percentage of the gross proceeds of the minerals produced. In this situation, it has been held that the person per-

forming the services is entitled to a depletion allowance if he receives an actual assignment of an interest in the minerals in place (*Dearing* v. *Commissioner*, 102 F. (2d) 91 (C. C. A. 5th); *F. H. E. Oil Company* v. *Commissioner*, 41 B. T. A. 130) but is not entitled to such an allowance in the absence of an assignment. *Commissioner* v. *Edwards Drilling Co.*, 95 F. (2d) 719 (C. C. A. 5th); *F. H. E. Oil Co.* v. *Commissioner, supra.*

Another ground for distinguishing this case from *Thomas* v. *Perkins* is the fact that in the *Thomas* case the oil payment was to be made in oil while here it was to be made in cash. A holding that a lessee who simply produces oil and turns it over to the lessor has not realized income from the oil is clearly not authority for a holding that a lessee who produces and sells oil and receives the proceeds therefrom has not realized income because he is under a contractual obligation to turn over a portion of the gross proceeds to the lessor in payment of the purchase price. *Cf. Waggoner Estate* v. *Wichita County*, 273 U. S. 113, 118. A similar distinction between payments in kind and payments in cash has been drawn in cases dealing with the declaration of corporate dividends. *Cf. General Utilities Co.* v. *Helvering*, 296 U. S. 200. And there would seem to be as substantial a difference between payments out of oil production and out of the gross proceeds of such production as there is between payment out of oil production and out of the net proceeds of such production, a distinction drawn

by this Court in *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372.[1]

3. Petitioners also rely on *Palmer* v. *Bender*, 287 U. S. 551. That case involved an assignment of a lease in return for a cash bonus, a future payment to be made "out of one-half of the first oil produced and saved" to the extent of $1,000,000, and an additional "excess royalty" of one-eighth of all the oil produced and saved. The question was whether the assignors were entitled to a depletion allowance with respect to payments made under this assignment. The Court held that they were entitled to such an allowance because they had retained "a right to share in the oil produced" and therefore "an economic interest in the oil, in place, which is depleted by production" (p. 557). In the present case, as we have shown, the Oklahoma Company

[1] In several cases the lower federal courts have held that the reservation of an oil payment right constitutes the retention of a capital investment in the property so that the oil payments are taxable as income to the lessor or assignor and the lessor or assignor is entitled to a depletion allowance with respect thereto. *Holly Development Co.* v. *Commissioner*, 93 F. (2d) 146 (C. C. A. 9th); *Commissioner* v. *Elliott Petroleum Corp.*, 82 F. (2d) 193 (C. C. A. 9th); *Fleming* v. *Commissioner*, 82 F. (2d) 324 (C. C. A. 5th); *Commissioner* v. *Williams*, 82 F. (2d) 328 (C. C. A. 5th); *Alexander* v. *Continental Petroleum Co.*, 83 F. (2d) 927 (C. C. A. 10th); *cf. Ortiz Oil Co.* v. *Commissioner*, 102 F. (2d) 508 (C. C. A. 5th). But see *Comar Oil Co.* v. *Burnet*, 64 F. (2d) 965 (C. C. A. 8th). Each of these cases is distinguishable from the present case on one or more of the grounds set forth above as distinguishing *Thomas* v. *Perkins*. However, the distinctions are not in every case satisfactory, and some of the decisions seem wrong in principle for the reasons stated above.

had no right to share in the oil in place and retained no capital investment in the properties; *Palmer* v. *Bender, supra,* is therefore inapplicable to the situation here presented.

Moreover, in the *Bender* case, the Government's argument was that the assignors were entitled to no depletion allowance whatever, and it made no contention that a distinction should be drawn between the royalty interest (the right to receive a percentage of all the oil and gas produced) and the oil payment right (the right to receive a specified sum of money out of a percentage of the first oil produced). The opinion of the Court, therefore, contains no discussion of any possible difference between these two rights but is directed primarily to the proposition that the assignors "retained, by their stipulations for royalties, an economic interest in the oil, in place, identical with that of a lessor" (p. 558).

It would, we submit, be completely unreal from an economic standpoint to treat the right of the Oklahoma Company to receive $110,000 out of one-half of the proceeds from sales of oil, gas, and land as an economic interest in the oil in place, similar to that retained by the holder of the royalty interest in *Palmer* v. *Bender*. In no sense can the right of the Oklahoma Company to the deferred payment of $110,000 be considered an investment in a wasting asset, since depletion, or even exhaustion, of the oil reserves caused by the production necessary to make this payment would not affect the value of the Company's right. Under these circumstances, to

allow the Company a deduction for depletion, similar to the deduction allowed to the taxpayer in *Palmer* v. *Bender*, would be to compensate it for an impairment of capital which it did not suffer. This is even more unrealistic where, as here, the assignment contract provided that the $110,000 could be paid out of the proceeds of the sale of the properties by Prichard, as well as out of the proceeds of the sale of oil and gas produced. Such a provision, as we have pointed out, is entirely inconsistent with the view that the Oklahoma Company retained an economic interest in the oil and gas in-place which was depleted when the payments to it were made.

Moreover, the decision in *Palmer* v. *Bender* was based, in part at least, upon the language of the depletion provisions of the Revenue Act there involved, which provided for a depletion allowance "according to the peculiar conditions in each case". (Revenue Act of 1921, Sec. 214 (a) (10)); this language was deemed to be "broad enough" to cover any person having an economic interest in the oil in place (287 U. S. at 557). The holding that the taxpayers there had such an economic interest as to be entitled to the depletion allowance was made without reference to the question whether the taxpayers, by virtue of this interest, derived income directly from the production and sale of the oil.[5]

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[5] The depletion provision of the Revenue Act of 1932 provides, as an alternative method of computing depletion, that a deduction of 27½ per centum be taken from "gross income from the property" (Sec. 114 (b) (3)); under this

4. It is true, of course, as petitioner contends, that the value of the Oklahoma Company's right to the deferred payment depended in part upon whether the amount of oil which could be produced from the properties would be sufficient to make the payment. This fact, however, clearly does not mean that the Oklahoma Company retained a capital investment in the oil and gas in place. In *Helvering* v. *O'Donnell*, 303 U. S. 370, and *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372, the Court held that where oil properties are conveyed under an agreement pursuant to which the taxpayer is to receive a percentage of the net profits of production and operation, the taxpayer has only a personal covenant, and not a capital investment in the oil and gas in place. The value of the personal covenant held by the taxpayers in those cases depended, of course, upon the amount of oil and gas which could be produced from the properties, but this fact was not deemed to entitle them to a depletion allowance because they had no capital investment in the minerals in place. Similarly, in *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362, 367, this Court expressly pointed out the distinction between a capital investment in oil and gas in place and "a mere economic advantage derived from production, through a contractual relation to the owner". These cases clearly establish that, in considering the nature of the

provision only those who derive income directly from production and sale of the oil are entitled to depletion. Cf. *Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S. 312.

Oklahoma Company's rights, the fact that the value of its contract depended in part upon whether there was sufficient oil in place to pay the $110,000 is immaterial; exhaustion of the properties before the payments were completed might have made the contract less advantageous to the Oklahoma Company, but this consideration by itself cannot serve to transmute what would otherwise be a contractual right into a capital investment.

While from an economic standpoint there may seem to be but a narrow distinction between a capital investment in the oil and gas in place, such as was deemed to be involved in *Palmer* v. *Bender* and *Thomas* v. *Perkins*, and a "mere economic advantage derived from production, through a contractual relation to the owner," such as is involved in this case and as was involved in the *O'Donnell*, *Elbe*, and *Bankline* cases, it is upon the basis of this distinction that the law has thus far been developed by this Court. Unless *Thomas* v. *Perkins* and that aspect of *Palmer* v. *Bender* which relates to oil payments (as distinguished from royalty payments) are to be reexamined, this distinction must, we submit, be deemed controlling.

5. A final word should be said about petitioners' contention that Prichard acted as a mere instrumentality or agency for collecting, receiving, and paying over to the Oklahoma Company money which belonged to it, and that he may not, therefore, be taxed with respect to such money. This contention is necessarily based on the premise that the Okla-

homa Company reserved an interest in the oil in place so that a portion of the proceeds from that oil belonged to it; so viewed, the contention has been answered by what has already been said. Moreover, it is clear that Prichard's agreement to pay the Oklahoma Company $110,000 out of one-half of the proceeds of the properties could not serve to convert him into a trustee, agent, or attorney in fact for the Oklahoma Company and thus exempt him from the tax; as we have pointed out (*supra*, pp. 10–11), a person who receives income from property owned by him is taxable thereon whatever anticipatory arrangement he may have made to deal with the income after he receives it. *Helvering* v. *Clifford*, No. 383, present Term; *Reinecke* v. *Smith*, 289 U. S. 172, 177; *Lucas* v. *Earl*, 281 U. S. 111; *Burnet* v. *Leininger*, 285 U. S. 136.[8]

[8] The cases cited by petitioner are all distinguishable on their facts and many of them are of doubtful authority. *Shellabarger* v. *Commissioner*, 38 F. (2d) 566 (C. C. A. 7th), has been limited to its own peculiar facts by the court which decided it (*Sarther Grocery Co.* v. *Commissioner*, 63 F. (2d) 68, 69 (C. C. A. 7th)) and the Court of Claims expressly declined to follow it. *Brewster* v. *United States*, 9 F. Supp. 686, 688. The decisions of the Circuit Court of Appeals for the Eighth Circuit in *Bettendorf* v. *Commissioner*, 49 F. (2d) 173, and *Central Life Assur. Soc. Mut.* v. *Commissioner*, 51 F. (2d) 939, have been greatly limited, if not overruled in principle, by that same court. *Marquette Oil Distribution Co.* v. *Commissioner*, 73 F. (2d) 205, 211. Moreover, the subsequent decision of the Circuit Court of Appeals for the Eighth Circuit in *Conar Oil Co.* v. *Burnet*, 64 F. (2d) 965, demonstrates that that court does not believe that the *Bettendorf* and *Central Life Assurance* cases are applicable to the type of situation here presented.

CONCLUSION

The decision of the court below should be affirmed.

Respectfully submitted.

FRANCIS BIDDLE,
Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
J. LOUIS MONARCH,
JOSEPH M. JONES,
Special Assistants to the Attorney General.
RICHARD H. DEMUTH,
Special Attorney.

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SUPREME COURT OF THE UNITED STATES.

Nos. 682, 683.—October Term, 1939.

J. Steve Anderson, Petitioner, 682 *vs.* Guy T. Helvering, Commissioner of Internal Revenue. L. H. Prichard, Petitioner, 683 *vs.* Guy T. Helvering, Commissioner of Internal Revenue.	On Writs of Certiorari to the United States Circuit Court of Appeals for the Tenth Circuit.

[May 20, 1940.]

Mr. Justice Murphy delivered the opinion of the Court.

Oklahoma City Company in 1931 owned certain royalty interests, fee interests, and deferred oil payments in properties in Oklahoma. During that year it entered into a written contract with petitioner Pritchard providing for the conveyance to him of these interests for the agreed consideration of one hundred sixty thousand dollars, payable fifty thousand in cash and one hundred ten thousand from one-half of the proceeds received by him which might be derived from oil and gas produced from the properties and from the sale of fee title to any or all of the land conveyed. Interest at the rate of 6% per annum was to be paid from the proceeds of production and of sales upon the unpaid balance. Oklahoma Company was to have in addition a first lien and claim against "that one-half of all oil and gas production and fee interest . . . from which the $110,000 is payable", the lien and claim "not in any way to affect the one-half interest in all oil and gas production and fee interest or the revenue therefrom which . . . [it] is to have and receive under this agreement." The proceeds derived from the oil and gas produced and from sales of the fee interests were to be paid directly to Pritchard who was to deposit one-half of them at a designated bank, at intervals of 90 days, to the credit of Oklahoma Com-

pany. The agreement recited that Oklahoma Company desired "to sell all of its right, title and interest of whatsoever nature" in the described properties, and provided that a copy of the agreement and a release be placed in escrow for delivery to Pritchard upon payment in full of the one hundred ten thousand dollars and interest. Immediately upon the execution of the contract the properties were conveyed to Pritchard without reservation.[1] In entering into the agreement Pritchard acted not only for himself but also for petitioner Anderson, each of them having a 45% interest.[2]

The gross proceeds derived from the production and sale of oil from the properties[3] during 1932 amounted to some eighty one thousand dollars. Pritchard, upon receiving this sum, distributed one-half to Oklahoma Company pursuant to the contract. The question for decision is whether the proceeds thus paid over to Oklahoma Company should be included in the gross income of petitioners for the tax year 1932.[4] The ruling of the Board of Tax Appeals against petitioners was affirmed by the Circuit Court of Appeals, 107 F. (2d) 459. Because of an asserted conflict with the applicable decisions of this Court, we granted certiorari, March 4, 1940.

It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable. That issue is, who has a capital investment in the oil and gas in place and what is the extent of his interest. *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362, 367; *Helvering* v. *O'Donnell*, 303 U. S. 370; *Helvering* v. *Elbe Oil*

1 Petitioners state that "the instruments of transfer of those properties were absolute and unqualified assignments and conveyances" and that there was "no reservation of any sort of interest, much less any legal interest specified in those assignments and conveyances".

2 The remaining 10% interest was acquired for one Olsen, whose case was consolidated with those of Pritchard and Anderson, and disposed of in the same opinion below, but who has not sought review here.

3 The record does not indicate what portion of the gross proceeds was derived from the production and sale of oil and gas and what portion, if any, was derived from sales of fees and from royalties on leases. The Commissioner in determining deficiencies against petitioners, however, added $11,276.39 to the gross income of each with the explanation that this amount represented "Oil payments received in connection with the Patterson [Oklahoma Company] Deal" not reported by petitioners. Respondent, in view of this explanation by the Commissioner and the omission from the record of any disclosure of the method of computing the $11,276.39 addition to gross income, accepts petitioners' statement that "the only income from the properties here in dispute is from oil production".

4 Revenue Act of 1932, C. 209, 47 Stat. 169.

Co., 303 U. S. 372; *Thomas* v. *Perkins*, 301 U. S. 655, 661, 663; *Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S. 312, 321; *Palmer* v. *Bender*, 287 U. S. 551. Compare *Helvering* v. *Clifford*, No. 383, October Term, 1939.

Oil and gas reserves like other minerals in place, are recognized as wasting assets. The production of oil and gas, like the mining of ore, is treated as an income-producing operation, not as a conversion of capital investment as upon a sale, and is said to resemble a manufacturing business carried on by the use of the soil. *Burnet* v. *Harmel*, 287 U. S. 103, 106-107; *Bankers Coal Co.* v. *Burnet*, 287 U. S. 308; *United States* v. *Biwabik Mining Co.*, 247 U. S. 116; *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, 521, 522; *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 414. The depletion allowed by production is likened to the depreciation of machinery or the using up of raw materials in manufacturing. *United States* v. *Ludey*, 274 U. S. 295, 302-303; *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364, 370. Compare *Von Baumbach* v. *Sargent Land Co.*, *supra*, at 524-525. The deduction is therefore permitted as an act of grace and is intended as compensation for the capital assets consumed in the production of income through the severance of the minerals. *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362, 366-367. The granting of an arbitrary deduction, in the interests of convenience, of a percentage of the gross income derived from the severance of oil and gas, merely emphasizes the underlying theory of the allowance as a tax-free return of the capital consumed in the production of gross income through severance. *Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S. 312, 321; *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459, 467.

The sole owner and operator of oil properties clearly has a capital investment in the oil in place, if anyone has, and so is taxable on the gross proceeds of production and is granted a deduction from gross income as compensation for the consumption of his capital. See *Burnet* v. *Harmel*, *supra*, at 107-108; *Helvering* v. *Clifford*, No. 383, October Term, 1939. By an outright sale of his interest for cash, such an owner converts the form of his capital investment, severs his connection with the production of oil and gas and the income derived from production, and thus renders inapplicable to his situation the reasons for the depletion allowance. "The words 'gross income from the property,' as used in the statute governing the

allowance for depletion, mean gross income received from the operation of the oil and gas wells by one who has a capital investment therein,—not income from the sale of the oil and gas properties themselves." *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372, 375-376.

Other situations, falling between the two mentioned, have been put on one side or the other as the cases arose. The holder of a royalty interest—that is, a right to receive a specified percentage of all oil and gas produced during the term of the lease—is deemed to have "an economic interest" in the oil in place which is depleted by severance. *Palmer* v. *Bender*, 287 U. S. 551, 557; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299; *Burnet* v. *Harmel*, 287 U. S. 103. See *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364. Cash bonus payments, when included in a royalty lease, are regarded as advance royalties, and are given the same tax consequences. *Burnet* v. *Harmel*, 287 U. S. 103; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299; *Bankers Pocahontas Coal Co.* v. *Burnet*, 287 U. S. 308. Compare *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372, 375. A share in the net profits derived from development and operation, on the contrary, does not entitle the holder of such interest to a depletion allowance even though continued production is essential to the realization of such profits. *Helvering* v. *O'Donnell*, 303 U. S. 370; *Helvering* v. *Elbe Oil Co.*, 303 U. S. 372. Similarly, the holder of a favorable contract to purchase wet gas at the mouth of the well is denied a depletion allowance on the difference between the contract price and the fair market value. *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362. Such an interest has been characterized by us as a "mere economic advantage derived from production, through a contractual relation to the owner". *Helvering* v. *Bankline Oil Co.*, *supra*, at 367.

Thomas v. *Perkins*, 301 U. S. 655, relied upon by petitioners, presented the issue whether the right to oil payments—that is, the right to a specified sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as and when produced—should be treated for tax purposes like the right to oil royalties or like the right to cash payments upon a sale. In that case, the assignment of lease provided for payments in oil only without the reservation of a royalty interest. The question was whether the assignees' gross income should include moneys paid to the assignors by purchasers of the oil. We stated (p. 659): "The granting clause in the assignment would be sufficient, if standing

alone, to transfer all the oil to the assignee. It does not specifically except or exclude any part of the oil. But it is qualified by other parts of the instrument. The provisions for payment to assignors in oil only, the absence of any obligation of the assignee to pay in oil or in money, and the failure of assignors to take any security by way of lien or otherwise unmistakably show that they intended to withhold from the operation of the grant one-fourth of the oil to be produced and saved up to an amount sufficient when sold to yield $395,000." Under these circumstances, the moneys received by the assignors from the sale of the oil were deemed not to be income to the assignees. See also *Palmer* v. *Bender*, 287 U. S. 551.

The holder of an oil payment right, as an original proposition, might be regarded as having no capital investment in the oil and gas in place. The value of the right, even though dependent upon the extent of the oil reserves, is fixed at the moment of creation and does not vary directly with the severance of the mineral from the soil. In this sense it resembles the right to cash payments more closely than the right to royalty payments. Yet it does depend upon the production of oil, ordinarily can be realized upon only over a period of years, and permits of a simple and convenient allocation between lessor and lessee of both the gross income derived from production and the allowance for depletion. Compare *Burnet* v. *Harmel*, 287 U. S. 103, 106-107. Accordingly, this Court in *Thomas* v. *Perkins* decided that the provision in the lease for payments solely out of oil production should be regarded as a reservation from the granting clause of an amount of oil sufficient to make the agreed payments, and should be given the same tax consequences as a provision for oil royalties. The decision did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for payments of that type. See *Palmer* v. *Bender*, 287 U. S. 551, 555-557; *Burnet* v. *Harmel*, 287 U. S. 103, 111.

The Government maintains that the present case is distinguishable from *Thomas* v. *Perkins* for the reason that the basis for decision there was that ownership of sufficient oil to make the payments had not been conveyed to the assignee but remained in the assignor. It asserts that the terms of the contract and the instruments of conveyance here negative any intention on the part of the parties to

withhold from the operation of the grant an amount of oil equal to the oil payments. The following factors, among others, are relied upon as supporting this contention: (1) the contract contains no qualifying language reserving from the grant any interest in the oil and gas in place; (2) the deferred payments of one hundred ten thousand dollars were payable in cash and not directly in oil; (3) the deferred payments drew interest until paid; (4) Oklahoma Company had a first lien and claim against one-half of the oil and gas production and fee interest; (5) petitioner Pritchard had the right to sell the fee interest covered by the contract and discharge the deferred payments out of the proceeds of such sale rather than out of the proceeds of the oil and gas production.

Several of the distinctions urged upon us by the Government are without substance. The economic consequences of the transaction are not materially affected by the circumstance that the provision for oil payments is not phrased in terms of a reservation from the conveyance to Oklahoma Company of an interest in the oil and gas in place. And the fact that the payments to Oklahoma Company are in cash rather than directly in oil is of no moment in determining the issues presented for decision. Compare, however, *General Utilities Co.* v. *Helvering*, 296 U. S. 200. Similarly, the retention of a lien, if it were construed as a lien only upon the oil and gas production, and nothing more,[5] would not make Oklahoma Company any the less dependent upon such production for payment of the amounts reserved.

The reservation of an interest in the fee, in addition to the interest in the oil production, however, materially affects the transaction. Oklahoma Company is not dependent entirely upon the production of oil for the deferred payments; they may be derived from sales of the fee title to the land conveyed. It is clear that payments derived from such sales would not be subject to an allowance for depletion of the oil reserves, for no oil would thereby have been severed from the ground; an allowance for depletion upon the proceeds of such a sale would result, contrary to the purpose of Congress, in a double deduction—first, to Oklahoma Company, second, to the vendee-owner upon the production of oil. *Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S. 312, 321. We are of opinion

[5] The lien here appears to cover both the oil and gas production and the fee interest from which the deferred payments were to be derived.

that the reservation of this additional type of security for the deferred payments serves to distinguish this case from *Thomas* v. *Perkins*. It is similar to the reservation in a lease of oil payment rights together with a personal guarantee by the lessee that such payments shall at all events equal the specified sum. In either case, it is true, some of the payments received may come directly out of the oil produced. But our decision in *Thomas* v. *Perkins* does not require that payments reserved to the transferor of oil properties shall for tax purposes be treated distributively, and not as a whole, depending upon the source from which each dollar is derived. An extension of that decision to cover the case at bar would create additional, and in our opinion unnecessary, difficulties to the allocation for income tax purposes of such payments and of the allowance for depletion between transferor and transferee. In the interests of a workable rule, *Thomas* v. *Perkins* must not be extended beyond the situation in which, as a matter of substance, without regard to formalities of conveyancing, the reserved payments are to be derived solely from the production of oil and gas. The deferred payments reserved by Oklahoma Company, accordingly, must be treated as payments received upon a sale to petitioners, not as income derived from the consumption of its capital investment in the reserves through severance of oil and gas.

Petitioners, as purchasers and owners of the properties, are therefore taxable upon the gross proceeds derived from the oil production, notwithstanding the arrangement to pay over such proceeds to Oklahoma Company. See *Helvering* v. *Clifford*, No. 383, October Term, 1939; *Reinecke* v. *Smith*, 289 U. S. 172, 177; *Old Colony Trust Co.* v. *Commissioner*, 279 U. S. 716.

Affirmed.

A true copy.

Test:

Clerk, Supreme Court, U. S.